

**WRITTEN TESTIMONY OF
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ACTING COMMISSIONER OF
INTERNAL REVENUE
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT
ON
THE 2008 FILING SEASON
MARCH 13, 2008**

Introduction

Chairman Lewis, Ranking Member Ramstad, and members of the Subcommittee, thank you for the opportunity to testify today on the 2008 Income Tax Filing Season. I would also like to update you on IRS operations, the progress we have made in the areas of taxpayer service and enforcement, our FY 2009 budget request, our latest efforts to improve voluntary compliance and reduce the tax gap, and the status of economic stimulus payments under the recently enacted economic stimulus program.

Overview

The IRS and its employees represent the face of U.S. government to more American citizens than any other government agency. We administer America's tax laws and collect over 96 percent of the revenues that fund the federal government each year.

The IRS strategic plan goals are:

- *Improve Taxpayer Service* – Help people understand their tax obligations, making it easier for them to comply with their obligations under the tax law.
- *Enhance Enforcement of the Tax Law* – Ensure taxpayers meet their tax obligations, so that when Americans pay their taxes, they can be confident their neighbors and competitors are also doing the same; and
- *Modernize the IRS through its People, Processes and Technology* – Strategically manage resources, associated business processes, and technology systems to meet service and enforcement strategic goals effectively and efficiently.

The FY 2009 IRS proposed budget, which I will discuss in detail later in my testimony, supports those strategic goals by retaining the critical balance between taxpayer service and compliance and enforcement.

2008 Filing Season

The biggest challenge we faced at the end of 2007, as we approached the 2008 Filing Season, was the uncertain status of legislation to address the situation of an additional 25 million taxpayers who otherwise would have become subject to the alternative minimum tax (AMT).

On October 30, 2007, Chairman Rangel, Ranking Member McCrery along with their counterparts on the Senate Finance Committee, sent me a letter assuring the IRS that Congress intended to enact AMT relief (the AMT patch) in a manner acceptable to the House of Representatives, the Senate, and the President. This letter was very helpful because it allowed IRS to move forward on certain planning and design aspects of implementing the AMT relief legislation, shortening the implementation process by a number of weeks.

However, as we advised at the time, we have key systems that can only accommodate one programming option without introducing excessive risk to the filing season. As a result, we were only able to proceed so far without actual legislation being enacted. When the President signed the AMT relief law on December 26, 2007, we immediately began the detailed reprogramming of systems to accommodate the new law. Our employees worked diligently to modify systems to implement the changes in a relatively short time period. My thanks go out to all of those dedicated IRS employees who worked nearly around the clock to enable us to implement this AMT relief legislation in record time.

Given their efforts we were able to begin the filing season on schedule for most taxpayers, but the processing of filed returns for approximately 13.5 million taxpayers that file one of five forms associated with the AMT legislation was delayed. These taxpayers had to wait until February 11 before having their filed return processed. Fortunately, due to historic filing patterns, most of these taxpayers do not regularly file until after February 11.

The other challenge facing us this filing season is the implementation of the economic stimulus program enacted by Congress in early February, specifically the planning for the distribution of the stimulus checks to eligible recipients throughout the country this spring. We will begin immediately after the close of the filing season to distribute those checks with the expectation that the first checks will be sent electronically the first week of May with the first paper checks being mailed by the second week.

To deliver the stimulus payments, we must program our systems to calculate the appropriate amount for each taxpayer based on their 2007 returns and then distribute the checks, through Treasury's Financial Management Service, based on the preferences expressed on that return by direct deposit or by paper check.

However, there are a significant number of economic stimulus recipients that typically do not have an income tax filing requirement. This would include retirees or those who have

minimal income and are thus not required to file. But in order to receive the stimulus payment, the recipient must file a tax return for 2007. To reach these recipients and educate them requires an extensive outreach program that includes the IRS coordinating with the Social Security Administration and Department of Veterans Affairs, along with private groups such as the AARP.

The chairman of the IRS Oversight Board recently put into words the attitude we are taking during this filing season. According to Paul Cherecwich, "Implementing the stimulus plan is a large and complex undertaking, and the IRS is devoting a lot of effort into the program. More management attention on the stimulus program stretches the IRS thin in other areas, but executing the filing season and stimulus program flawlessly is the IRS' highest priority at the moment."

Despite the challenges presented by the late enactment of the AMT patch and the implementation of the economic stimulus payments, I am proud to report that thus far the filing season has gone very well. Allow me first to give an update on some of the numbers we are looking at approximately one month from the due date for individual tax returns.

Numbers Thus Far

We expect to process nearly 140 million individual tax returns in 2008, and we anticipate continued growth in the number of those that are e-filed. In the 2007 filing season, almost 60 percent of all income tax returns were e-filed. We fully expect to exceed that number this year. As of March 1, we have received nearly 44 million tax returns electronically, an increase of 6.3 percent compared to the number of returns that were e-filed during the same period last year.

This increase in e-filing is being driven by people preparing their own returns using their personal computers. The total number of self-prepared returns that are e-filed is up by almost 15 percent compared to the number of self-prepared returns filed during the same period a year ago. Over 14 million returns have been e-filed by people from their personal computers, up from over 12.2 million for the same period a year ago.

Overall, 78 percent of the 55.7 million returns filed through March 1 have been e-filed. Encouraging e-filing is good for both the taxpayer and for the IRS. Taxpayers who use e-file can generally have their tax refund deposited directly into their bank account in two weeks or less. That is about half the time it takes us to process a paper return. For the IRS the error-reject rate for e-filed returns is significantly lower than that for paper returns.

More people are choosing to have their tax refunds deposited directly into their bank account than ever before. So far this year, we have directly deposited over 37.7 million refunds, or 81 percent of all refunds issued this tax filing season.

People are also visiting our web site – IRS.gov – in record numbers. We have recorded almost 82.6 million visits to our site this year, up over 11 percent from 74.1 million for the same period a year ago. The millions of taxpayers that have visited IRS.gov have benefited from many of the services that are available through the web site. We have made it easier for taxpayers to get answers to many of their tax questions online. The web site:

- Allows taxpayers to obtain information on the economic stimulus rebate program;
- Assists the taxpayer in determining whether he or she qualifies for the Earned Income Tax Credit (EITC);
- Assists the taxpayer in determining whether he or she is subject to the Alternative Minimum Tax (AMT);
- Allows more than 70 percent of taxpayers the option to file their tax returns at no cost through the Free File program;
- Allows taxpayers who are expecting refunds to track the status via the “Where’s My Refund?” feature; and
- Allows a taxpayer to calculate the amount of their deduction for state and local sales taxes.

As of March 1, we have received over 55.7 million returns, an increase of 3.17 percent over the same period as last year. We have issued 46.5 million refunds so far this year, for a total of \$122.7 billion. The average refund thus far is \$2,637, approximately \$59 more than last year. In addition, over 19.1 million taxpayers have tracked their refund on IRS.gov, up 20.7 percent over last year.

As of March 1, our Taxpayer Assistance Centers (TACs) are reporting over one million taxpayers assisted. Our telephone assistors have answered almost 7.4 million calls, and 10.8 million callers received automated services.

Free File

Over 2.5 million people have utilized Free File as of March 1, up over 12 percent compared to the number of taxpayers that used Free File during the same period a year ago. This year anyone with adjusted gross income of \$54,000 or less is eligible for Free File, which includes 97 million taxpayers. The number of Free File returns compared to the prior year has been steadily increasing, and we expect to meet or exceed 2007 totals by the end of the filing season. One reason for this increase is that we have committed resources to market and promote the Free File program.

In the 2006 filing season an indicator was included for the first time on Free File returns, which allowed the IRS to identify those taxpayers using Free File. As a result, we obtained important information such as customer satisfaction and demographic data that had never before been available.

VITA/TCE Sites and Other Community Partnerships

The use of tax return preparation alternatives, such as volunteer assistance at Volunteer Income Tax Assistance (VITA) sites and Tax Counseling for the Elderly sites (TCEs), has steadily increased over the years. In 2007, over 2.6 million returns were prepared by volunteers. As of March 1, volunteer return preparation is up 10.6 percent compared to the number of volunteer returns filed by during the same period a year ago. Volunteer e-filing is also up slightly, by 2.1 percent over the same period in the last tax filing season. This is reflective of continuing growth in existing community coalitions and partnerships.

We have also made a concerted attempt to expand outreach to taxpayers, particularly those taxpayers who may be eligible for the EITC. For example, we sponsored EITC Awareness Day on January 31st, in an effort to partner with our community coalitions and partnerships to reach as many EITC-eligible taxpayers as possible and urge them to claim the credit. Over 125 coalitions and partners hosted local news conferences and issued more than 100 press releases highlighting EITC Awareness Day this year.

A Commitment to Service, Enforcement and Modernization

In FY 2007, we continued making improvements in our service and enforcement programs as well as having significant successes in our IT modernization program.

Taxpayer Service

According to most of our taxpayer service metrics, we continued to see improvement in FY 2007. The numbers in our telephone services, electronic filing, and IRS.gov access have all increased. This is demonstrated by the following FY 2007 business results:

- More taxpayers chose to file electronically in 2007 than during the prior year, with 57 percent of individual tax filers choosing to e-file in 2007, up from 54 percent in 2006.
- More people visited the IRS website – IRS.gov. The IRS website was accessed more than 215 million times in 2007, up 10 percent from the same period in 2006.
- The IRS helped more taxpayers find out about their refunds through the agency's internet-based system 'Where's My Refund?' The system was accessed 32.1 million times during 2007, up 30 percent from last year's usage of 24.7 million.
- The IRS provided a high level of service for taxpayers seeking traditional phone-based or in person assistance. In FY 2007, the IRS customer assistance call

centers answered 33.2 million assistor telephone calls and 21.1 million automated calls. We maintained an 82.1-percent level of service on the telephone with an accuracy rate of 91.2 percent on tax law questions.

- The agency maintained a 94-percent customer satisfaction rating for its toll-free telephone service.
- Outreach and educational services were enhanced through partnerships between the IRS and public organizations. Through its 11,922 Volunteer Income Tax Assistance and Tax Counseling for the Elderly sites, the IRS provided free tax assistance to the elderly, disabled, and limited English proficient individuals and families. Over 76,000 volunteers filed 2.63 million returns. Additionally, the IRS established 6 new clinics in rural areas to help low-income taxpayers meet their tax obligations.
- The IRS successfully implemented the Telephone Excise Tax Refund (TETR), a one-time payment available on federal income tax returns to refund previously collected long distance telephone taxes. Successful delivery of the integrated TETR approach enabled the filing of nearly 98 million individual and business tax returns in 2006, claiming approximately \$5.48 billion in telephone excise tax refunds. Some individual and business returns for 2006 are continuing to be filed claiming TETR refunds. In addition, the IRS prevented more than \$538 million in potential erroneous refunds with the aid of a return selection tool created specifically to catch questionable TETR requests.
- The IRS also introduced a split refund capability, which allowed taxpayers to direct deposit their refund into as many as three financial accounts.

Another development in our taxpayer service program is the Taxpayer Assistance Blueprint (TAB). This collaborative effort of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate began in July, 2005 in response to a Congressional mandate to develop a five-year plan that outlines the steps we should take to improve taxpayer services.

TAB represents a significant milestone in a decade-long history of service enhancements by the IRS. During this period taxpayer satisfaction with IRS services has grown significantly, due in large part to the strength of our commitment to continual improvements. Increases in electronic filing and on-line service transactions, high levels of toll-free access and accuracy, extensive stakeholder engagement, and increasingly diversified efforts to reach taxpayers through local partners and community coalitions have all led to better taxpayer understanding and participation in the tax system.

Several notable accomplishments in FY 2008 include:

- Established the Taxpayer Services Program Management Office and Services Committee to provide senior executive coordination and governance to TAB implementation;

- Implemented an Estimated Wait Time announcement to inform taxpayers about their expected wait time in the telephone queue prior to reaching a customer service representative;
- Implemented Spanish “Where's My Refund,” which adds refund status to the Spanish web page on IRS.gov that mirrors English-based refund information;
- Launched an electronically searchable Publication 17, Your Federal Income Tax on IRS.gov;
- Enhanced training for volunteers in the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs; and
- Released tax publications in new languages, including Chinese, Russian, Korean, and Vietnamese.

Expanding Enforcement Efforts

The most prominent measure of our success in improving compliance is the increase in enforcement revenue, which has risen from \$33.8 billion in FY 2001 to \$59.2 billion in FY 2007, an increase of 75 percent. This represents a 5.6 to 1 return on investment for all IRS activities in FY 2007 from enforcement revenue alone.

In FY 2007, both the levels of individual returns examined and coverage rates have risen substantially. We conducted nearly 1.4 million examinations of individual tax returns in FY 2007, an 8 percent increase over FY 2006. This is over three-quarters more than were conducted in FY 2001, and reflects a steady and sustained increase since that time. Similarly, the audit coverage rate has risen from 0.6 percent in FY 2001 to 1 percent in FY 2007. This increase was achieved without a significant increase in resources as compared to the previous fiscal year.

While the growth in examinations of individual returns is visible in all income categories, it is most visible in examinations of individuals with incomes over \$1 million. Audits of these individuals increased from 17,015 during FY 2006 to 31,382 during FY 2007, an increase of 84 percent. One out of 11 individuals with incomes of \$1 million or more faced an audit in 2007. Their coverage rate has risen from 5 percent in FY 2004 to 9.25 percent in FY 2007.

In the business arena, the IRS has continued efforts to review more returns of flow-through entities – partnerships and S Corporations. Our business statistics reflect that we have placed more emphasis in the growing area of these flow-through returns. While large corporate audits are down slightly, we have increased our focus on mid-market corporations – those with assets between \$10 million and \$50 million.

The IRS enforcement budget in FY 2007 was similar to the budget in FY 2006, and in times of flat budgets, the agency cannot increase activity across the board but must address the areas where there is growth and potential risk.

- Audits of S Corporations increased to 17,681 during FY 2007, up 26 percent from the prior year's total of 13,984.
- Audits of partnerships increased to 12,195 during FY 2007, up almost 25 percent from the prior year's total of 9,777.
- Audits of mid-size corporations increased to 4,473, up 6 percent from last year's total of 4,218.
- Audits of businesses in general rose to 59,516, an increase of almost 14 percent from the prior year's total of 52,223.
- Although the audits of large corporations dipped slightly in FY 2007 to 9,644 audits, the number of audits is up 14 percent from the FY 2002 level.

Finally, examinations of tax-exempt organizations have also risen. In FY 2001 5,342 tax-exempt organization examinations were closed. This number rose to 7,580 in FY 2007.

Delivering Modernization

The IRS' Business Systems Modernization (BSM) program continues to improve its delivery performance, meeting schedule and cost estimates for the vast majority of releases over the past three years, and delivering significant business value. Over the past six months, the IRS has had a number of notable accomplishments in its modernization efforts:

1. **Customer Accounts Data Engine (CADE).** CADE Release 3.2 was delivered on time (January 14, 2008) for this filing season and is doing well in production. In fact, as of the end of February, CADE had processed 12.7 million returns, which is more than 25 percent of all individual returns filed to date for this year. CADE not only stores the taxpayer data on a modernized data base, but also settles daily (akin to a modern banking institution), which enables CADE to process refunds on average four days faster than the IRS master file. In addition, the updated account information is immediately available for our customer service personnel, unlike the master file, which is only updated on a weekly basis.
2. **Account Management Services (AMS).** AMS is a strategic program designed to deliver improved support and functionality to IRS employees by bridging the gap between modernization initiatives like CADE and existing legacy systems. AMS enables authorized users to access, validate, and update taxpayer accounts on demand.

AMS Release 1.1 provides on-line address change capability for CADE accounts. The first release of AMS accomplished an historic achievement for IRS when it delivered the capability to update authoritative account data on a daily cycle to 33,539 IRS customer service representatives. Release 1.1 was deployed on time and on budget in October 2007, and through February 25, 2008, has completed over 365,000 address changes.

AMS Release 1.2 provides improved customer support with new inventory and workflow functionalities to automate the assignment, research, resolution, and closure for entity and account transcripts and transition from a paper-based manual process to an automated on-line process. Release 1.2A pilot was deployed on February 18, 2008.

3. **Modernized e-File (MeF).** MeF is the IRS' designated e-File platform (electronic filing system) for the future and provides e-Filing capability for large corporations, small businesses, partnerships, and non-profit organizations. MeF benefits both taxpayers and the IRS by enabling taxpayers to file all of their tax forms electronically, eliminating the need for IRS personnel to match paper documents to electronic returns. Additionally, the enhancements embedded within MeF allow more robust error checking and data validation before returns are processed, reducing the number of returns that need manual intervention and correction.

MeF to date has accepted over 4 million tax returns. The first five weeks of CY 2008 MeF accepted over 61,000 returns, a 112-percent increase over the same period in CY 2007. MeF Release 5 went into production as planned in January 2008 and provides the ability to file electronically Form 1120F (tax returns for foreign corporations) and Form 990N (so called electronic postcard for small tax exempt organizations to meet their filing requirement). The next major release, Release 6, is scheduled for deployment in August 2009, and will begin the transition of Form 1040 returns from the IRS legacy e-filing system to MeF.

The recent successes of BSM are due to the maturation of many key management processes resulting in better management of its IT investments and better performance in delivering its modernized systems. Much of this improvement is attributable to IRS' enhanced IT governance process and its IT Modernization Vision and Strategy (MV&S), which have enabled the IRS to use its resources more effectively by working closer with the business to match IT investments to business needs; delivering smaller, incremental system releases; and leveraging existing systems where appropriate.

President's FY 2009 Budget Funds Taxpayer Service and Enforcement

The President's FY 2009 Budget request for the IRS supports not only our five-year strategic plan, but also the tax compliance strategies addressed in *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* sent to Congress last summer and the *IRS Taxpayer Assistance Blueprint*, which I discussed earlier in my statement.

These documents underscore the IRS' commitment to provide quality service to taxpayers while enforcing America's tax laws in a balanced manner.

The President's FY 2009 Budget request supports improving compliance by funding activities that promote better tax administration and compliance with the tax laws. The President's FY 2009 Budget request for the enforcement program is \$7,487,209,000, an increase of \$489,983,000, or 7 percent, over the FY 2008 enacted level. The Administration proposes to include these enforcement increases as a Budget Enforcement Act program integrity cap adjustment. The enforcement program is funded from the Enforcement appropriation and part of the IRS' Operations Support appropriation.

Budget Request

For FY 2009, the President is requesting a total of \$11,361,509,000 for IRS activities. This is a \$469,125,000 increase, or an increase of 4.3 percent, over the FY 2008 enacted level.

The overall IRS budget is broken down into the following five areas:

- Taxpayer Services – The FY 2009 requested level for this area is \$2,150,000,000. This is the same as the FY 2008 enacted level. Included in this area are the following activities:
 - Pre-Filing Taxpayer Assistance and Education (\$617,326,000) – This budget activity funds services to assist with tax return preparation, including tax law interpretation, publication production, and advocate services.
 - Filing and Account Services (\$1,532,674,000) – This budget activity funds programs that provide filing and account services to taxpayers, process paper and electronically submitted tax returns, issue refunds, and maintain taxpayer accounts.
- Enforcement – The FY 2009 request is \$5,117,267,000. This is an increase of 7.1 percent from the FY 2008 enacted level. As mentioned earlier, the Operations Support budget provides an additional \$2.3 billion to support enforcement activities. Included in the specific enforcement area are the following activities:
 - Investigations (\$603,466,000) – This budget activity funds the criminal investigations programs that explore potential criminal violations of the internal revenue tax laws, enforce criminal statutes relating to these violations, and recommend prosecution as warranted.
 - Exam and Collections (\$4,363,826,000) – This budget activity funds programs that enforce the tax laws and compliance through examination and collection programs that ensure proper payment and tax reporting. The budget activity also supports appeals and litigation activities associated with exam and collection.

- Regulatory (\$149,975,000) – This budget activity funds the development and printing of published IRS guidance materials; interpretation of tax laws; advice on general legal servicing, ruling and agreements; enforcement of regulatory rules, laws, and approved business practices; and supporting taxpayers in the areas of pre-filing agreements, determination letters, and advance pricing agreements. The Office of Professional Responsibility is also funded within this budget activity.
- Operations Support – The FY 2009 request is \$3,856,172,000. This is an increase of 4.8 percent from the FY 2008 enacted level. Included in this area are the following activities:
 - Infrastructure (\$883,325,000) – This budget activity funds administrative services related to space and housing, rent and space alterations, building services, maintenance, guard services, and non-Automated Data Processing (ADP) equipment.
 - Shared Services and Support (\$1,243,703,000) – This budget activity funds policy and management, IRS-wide support for research, strategic planning, communications and liaison, finance, human resources, and equal employment opportunity and diversity services and programs. It also funds printing and postage, business systems planning, security, corporate training, legal services, procurement, and specific employee benefits programs.
 - Information Services (\$1,729,144,000) – This budget activity funds staffing, equipment, and related costs to manage, maintain, and operate the information systems critical to the support of tax administration programs.
- Business Systems Modernization – The FY 2009 request is \$222,664,000. This is a reduction of 16.6 percent from the FY 2008 enacted level. This appropriation funds the planning and capital asset acquisition of information technology to modernize the IRS business systems, including labor and related contractual costs.
- Health Insurance Tax Credit Tax Administration. The FY 2009 request for this program is \$15,406,000. This is an increase of 1.1 percent from the FY 2008 enacted level. This appropriation funds costs to administer a refundable tax credit for health insurance to qualified individuals, which was enacted as part of the Trade Adjustment Assistance Reform Act of 2002.

The justification for the requests in each of these areas is discussed in detail below.

Adjustments from FY 2008 Levels to Help Reduce the Tax Gap

The IRS total requested funding increase for FY 2009 is \$469,125,000. This increase will go to improving voluntary compliance and reducing the tax gap. These investments fund increased front-line enforcement efforts, enhanced research, and implementation of

legislative proposals to improve compliance. By FY 2011, these investments are projected to increase annual enforcement revenue by \$2.0 billion. In addition, the legislative proposals included in the FY 2008 Budget to improve tax compliance are estimated to generate \$36 billion over the next ten years.

Specific increases to improve voluntary compliance include:

- Reduce the Tax Gap for Small Business and the Self Employed (+\$168,498,000 / +1,608 FTE) – This enforcement initiative will increase enforcement efforts to improve compliance among small business and self-employed taxpayers by: increasing audits of high-income returns, increasing audits involving flow-through entities, implementing voluntary tip agreements, increasing document-matching audits, and collecting unpaid taxes from filed and non-filed tax returns. This request will generate \$981 million in additional annual enforcement revenue once new hires reach full potential in FY 2011.
- Reduce the Tax Gap for Large Businesses (+\$69,488,000 / +519 FTE) – This enforcement initiative will increase examination coverage of large and mid-size corporations, including multi-national businesses, foreign residents, and smaller corporations with significant international activity. It will also enable the IRS to use existing systems further to capture other electronic data through scanning and imaging. The initiative will allow the IRS to address risks arising from the rapid increase in globalization, and the related increase in foreign business activity and multi-national transactions where the potential for non-compliance is significant. Funding of this request will generate \$544 million in additional annual enforcement revenue once the new hires reach full potential in FY 2011.
- Improve Tax Gap Estimates, Measurement, and Detection of Non-Compliance (+\$51,058,000 / +393 FTE) – This enforcement initiative will support and expand ongoing research studies, including the National Research Program, of filing, payment, and reporting compliance to provide a comprehensive picture of the overall taxpayer compliance level. Research allows the IRS to target better specific areas of noncompliance, improve voluntary compliance, and allocate resources more effectively to reduce the tax gap. Improved research data will also refine workload selection models reducing audits of compliant taxpayers. The audits associated with these studies will generate \$16 million in additional annual enforcement revenue once the new hires reach full potential in FY 2011 and the research they provide will help us achieve the high rate of return (5.6 to 1 in FY 2007) that we receive from our enforcement programs.
- Increase Reporting Compliance of U.S. Taxpayers with Offshore Activity (+\$13,697,000 / +124 FTE) – This enforcement initiative will address domestic taxpayer offshore activities. Abusive tax schemes, reporting of flow-through income, and high-income individuals are prime channels or candidates for tax avoidance. This initiative will focus on uncovering offshore credit cards, disguised corporate ownership, and brokering activities in order to identify

individual taxpayers who are involved in offshore arrangements that facilitate noncompliance. Funding of this request will generate \$102 million in additional annual enforcement revenue once the new hires reach full potential in FY 2011.

- Expand Document Matching (+\$35,060,000/+413 FTE) – This enforcement initiative will increase coverage within the Automated Underreporter (AUR) program. This program matches third-party information returns (e.g., Form W-2 and Form 1099 income reports) against income claimed on tax returns. When potential underreporting is discovered taxpayers are contacted to resolve the issue. This request will produce \$359 million in additional annual enforcement revenue once the new hires reach full potential in FY 2011.
- Implement Legislative Proposals to Improve Compliance (+\$23,045,000 /0 FTE) – While the IRS continues to address compliance by improving customer service and using traditional methods of enforcement, the FY 2009 Budget also includes several legislative proposals that would provide additional enforcement tools to improve compliance, if enacted. It is estimated that these proposals will generate \$36 billion in revenue over ten years. The proposals would expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties. This enforcement initiative includes funding for purchasing software and making modifications to the IRS IT systems necessary to implement the proposals. The specific legislative proposals are listed later in my testimony.

Other Adjustments from FY 2008 Levels

Other significant adjustments to the FY 2009 Budget proposal, relative to the FY 2008 appropriated levels, includes the following:

- Adjustments Necessary to Maintain Current Levels (+\$264,985,000 / 0 FTE) – Funds are requested for: FY 2009 cost of the January 2008 pay increase of \$57,854,000; proposed January 2009 pay raise of \$152,303,000; and non-labor related items such as contracts, travel, supplies, equipment and GSA rent adjustments of \$54,828,000.
- Efficiency savings that include the following:
 - Efficiency Savings (-\$71,356,000 / -769 FTE) – The IRS continues to improve the efficiency of all of its programs. The Budget reflects efficiency savings in the Enforcement and Operations Support accounts. Enhancements of technology; improved workload selection models; on-going management productivity and efficiency improvements; and streamlining, centralizing, and consolidating work processes and programs will lead to operational efficiencies resulting in significant savings in FY 2009.

- Increase e-File savings (-\$10,300,000 / -207 FTE) – This program decrease is a result of savings from increased electronic filing (e-File), which is projected to lead to 4.2 million fewer returns filed on paper (3.5 million individual and 0.7 million business) in FY 2009. This budget request proposes to reinvest these savings to cover the costs of Increase Efficiency through Submission Processing Consolidations and Address Correspondence Inventory.
- Non-Recur Savings (-\$12,593,000 / 0 FTE) – This reflects non-recurring, one-time costs associated with the IRS FY 2008 initiatives, such as new hire training, background investigations, and acquisition of telecommunications equipment, computers, and printers.
- Program Decreases
 - Taxpayer Assistance Centers and Outreach (-\$31,200,000 / -99 FTE) – Additional resources were provided in FY 2008 for increasing outreach and education activities. Many of these investments are long-term, nonrecurring investments that will benefit taxpayers for many years, including enhancements to the website and expansion of facilitated self-assistance terminals in the Taxpayer Assistance Centers. In FY 2009, the IRS will continue to work to implement other taxpayer assistance improvements detailed in the Taxpayer Assistance Blueprint (TAB).
 - Taxpayer Advocate Service (-\$7,711,000 / -25 FTE) – Additional Taxpayer Advocate Service (TAS) funds were provided in FY 2008 to expand TAS case processing activities. In FY 2009, these activities will be restored to levels in line with resources for other taxpayer service programs. The IRS does request \$2.7 million in additional TAS funding to support the FY 2009 enforcement initiatives.
 - Volunteer Income Tax Assistance Grants Program (-\$8,000,000 / 0 FTE) – Funds provided in FY 2008 included \$8,000,000 for a new Volunteer Income Tax Assistance (VITA) matching grant demonstration program for tax return preparation assistance. This funding is available until September 30, 2009. Given the ramp-up time to establish the grant application and approval process, these grants will be issued for the 2009 filing season.
 - Business Systems Modernization (BSM) (-\$45,780,000 / -25 FTE) – The FY 2009 proposed level of \$222,664,000 will allow continued progress on key modernization projects including the Customer Account Data Engine (CADE), Accounts Management Services (AMS), and Modernized e-File (MeF).

Specific Legislative Proposals

The President's FY 2009 Budget includes a number of legislative proposals intended to improve tax compliance while minimizing the burden on compliant taxpayers as much as possible. If enacted, it is estimated that these proposals will generate an additional \$36 billion over the next ten years (see the Treasury Blue Book, available on the Treasury Department web site, for more information). The Administration proposes to expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties.

- *Expand information reporting* – Compliance with the tax laws is highest when payments are subject to information reporting to the IRS. Specific information reporting proposals would:
 - 1) Require information reporting on payments to corporations;
 - 2) Require basis reporting on security sales;
 - 3) Require information reporting on merchant payment card reimbursements;
 - 4) Require a certified Taxpayer Identification Number (TIN) from contractors;
 - 5) Require increased information reporting on certain government payments;
 - 6) Increase information return penalties; and
 - 7) Improve the foreign trust reporting penalty.
- *Improve compliance by businesses* – Improving compliance by businesses of all sizes is important. Specific proposals to improve compliance by businesses would:
 - 1) Require electronic filing by certain large organizations; and
 - 2) Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes.
- *Strengthen tax administration* – The IRS has taken a number of steps under existing law to improve compliance. These efforts would be enhanced by specific tax administration proposals that would:
 - 1) Expand IRS access to information in the National Directory of New Hires for tax administration purposes;
 - 2) Permit disclosure of prison tax scams;
 - 3) Make repeated willful failure to file a tax return a felony;
 - 4) Facilitate tax compliance with local jurisdictions;
 - 5) Extend statutes of limitations where state tax adjustments affect federal tax liability; and
 - 6) Improve the investigative disclosure statute.

- *Expand penalties* – Penalties play an important role in discouraging intentional non-compliance. A specific proposal to expand penalties would impose a penalty on failure to comply with electronic filing requirements.

Improve Tax Administration and Other Miscellaneous Proposals

The Administration has put forward additional proposals relating to IRS administrative reforms. Five of these proposals are highlighted below:

- The first proposal modifies employee infractions subject to mandatory termination and permits a broader range of available penalties. It strengthens taxpayer privacy while reducing employee anxiety resulting from unduly harsh discipline or unfounded allegations.
- The second proposal allows the IRS to terminate installment agreements when taxpayers fail to make timely tax deposits and file tax returns on current liabilities.
- The third proposal eliminates the requirement that the IRS Chief Counsel provide an opinion for any accepted offer-in-compromise of unpaid tax (including interest and penalties) equal to or exceeding \$50,000. This proposal requires that the Secretary of Treasury establish standards to determine when an opinion is appropriate.
- The fourth proposal extends the IRS authority to use the proceeds received from undercover operations through December 31, 2012. The IRS was authorized to use proceeds it received from undercover operations to offset necessary and reasonable expenses incurred in such operations. The IRS authority to use proceeds from undercover operations expired on December 31, 2007.
- The fifth proposal equalizes penalty standards between tax return preparers and taxpayers, reducing unnecessary conflicts of interest between them. The standard applicable to tax return preparers for disclosed positions would be “reasonable basis,” but for certain reportable transactions with a significant purpose of tax avoidance, the existing standard would persist, i.e., the preparer should have a reasonable belief that the position, more likely than not, would be sustained on the merits.

Other IRS Programs

There are two other programs that I know are of great interest to the Subcommittee, but are not directly related to the filing season, on which I would like to update you.

Private Debt Collection

Since 2006, the IRS has had in place a program to utilize private debt collectors to collect certain tax debts from delinquent taxpayers. The program was authorized by the

American Jobs Creation Act of 2004. The first cases were assigned to private collectors in September 2006, only after IRS screened potential contractors and then trained them on taxpayer rights and IRS procedures.

Since its inception through late January 2008, we have placed cases involving over 90,000 entities. These 90,000 entities involve nearly 158,000 cases or modules, totaling \$848 million. We have received full payments from over 10,000 taxpayers and approved installment agreements with another 4,600.

We have received actual payments of \$43.5 million. We have paid out commissions of \$7.3 million leaving net receipts of \$36.2 million.

For the period April 1, 2007 through January 31, 2008, the taxpayer satisfaction score with these collection activities is 95 percent. We have a Regulatory and Procedural Accuracy rate of 98.8 percent, a timeliness score of 99.3 percent and a professionalism score of 99.9 percent. The program is on target with our revised economic projections and is recovering more money each year than the IRS spends to run the program. And, according to those revised projections, we expect the program to fully recover the “sunk costs” that were used to get the program up and running in FY 2010. We have 95 instances of reported contract concerns, which is about one-tenth of one percent of the entities placed and of those, we have validated 5 cases in which penalties have been imposed.

We listened carefully to some of the criticisms expressed at the hearing last May and have tried to make improvements to address some of those recommendations. For example, we now provide the latest taxpayer phone number that we have to the private collection agent (PCA) to increase the likelihood that they will reach the correct taxpayer. We have also given the contractor the date of birth of the taxpayer as an additional authentication point. In addition, we have revised the letter to those taxpayers indicating they have received a previous IRS or PCA letter but who refuse to authenticate. The new letter advises that refusal to authenticate will result in the case being returned to the IRS.

PCAs can now also disclose to the taxpayer the reason for the call. They can say they are calling on behalf of the IRS when they believe they are talking to the taxpayer. They can also leave voicemail message saying they are calling on behalf of the IRS if they believe they have reached the correct taxpayer. Finally, PCAs have been given increased flexibility in authenticating the taxpayers social security number (SSN). Now if the taxpayer is reluctant to give their full SSN, the PCA can authenticate the taxpayer by using any four digits of the SSN, not just the last four digits.

We believe these improvements will increase the likelihood that we reach the correct taxpayer and that the taxpayer is more likely to understand the nature of the call.

Identity Theft

Combating identity theft is a major priority for the IRS. We continue to look for opportunities to make our efforts more effective and efficient in the areas of identity-theft awareness, prevention, detection, and prosecution.

To strengthen our enterprise-wide approach to identity theft, IRS established the Privacy, Information Protection, and Data Security (PIPDS) office in July 2007. PIPDS is led by a Senior Executive who reports directly to the Deputy Commissioner for Operations Support, which enables the office to reach across all IRS organizations and ensure that proper attention and discipline are given to the issues of privacy, identity theft, and data security.

We created the Identity Theft and Incident Management (ITIM) office within PIPDS to continue implementing the IRS identity-theft strategy and coordinate efforts within the IRS to provide assistance and consistent treatment to taxpayers who are victims of identity theft.

The IRS is also updating our identity-theft strategy to reflect the implementation of several recommendations outlined in the President's Identity Theft Task Force report for preventing and deterring identity theft. We have initiated efforts targeted at decreasing the unnecessary use of Social Security Numbers (SSN), implementing data security guidelines and rules, responding to data losses, and where appropriate, collaborating with law enforcement agencies to identify and prosecute identity theft associated with criminal tax and money-laundering violations affecting tax administration.

The IRS generally encounters two primary types of identity theft that relate to tax administration: (1) the misreporting of income and (2) the filing of questionable tax returns generally claiming a refund.

- **Misreporting of Income** – This type of identity theft involves an individual using another person's name and SSN to obtain employment. Because income earned is reported to the IRS by the employer, it will appear to the IRS that the lawful taxpayer did not report all income on his or her tax return. These cases are primarily resolved by the Compliance function through the Automated Underreporter (AUR) program. The AUR program matches information reported on information returns (e.g., Form W-2 and Form 1099) submitted by third parties, such as banks, employers, and other payers against the information submitted by taxpayers on their individual income tax returns. The IRS has updated its AUR process to provide assistance to victims whose identities have been stolen for employment purposes. If the taxpayer provides the necessary documentation on an identity-theft claim, the income in question will not result in an additional assessment, and the IRS can close the case.
- **Questionable Tax Returns** – This second type of identity theft involves an individual using another person's SSN to file a tax return in order to obtain a tax refund. These cases are primarily resolved by the Criminal Investigation division (CI), the investigative law-enforcement arm of the IRS, and Accounts

Management function within our Wage and Investment division. Because duplicate returns filed with a single SSN do not always involve identity theft, the IRS first tries to determine whether there is another reason for the duplicate filing, such as IRS transcription errors, a single taxpayer filing multiple returns for the same year to correct mistakes, or transposition errors by the taxpayer (the most common cause). If this is not the case, employees in Accounts Management make every effort to locate a correct SSN for the taxpayers and resolve the duplicate filing situation before contacting the taxpayers. If Accounts Management is unable to resolve the issue definitively through research and contact with the taxpayers, the common number is “scrambled” and both taxpayers are assigned a temporary number (IRSN) to file future tax returns pursuant to IRS “Scrambled SSN” procedures.

While the IRS recognizes that there is more work to be done to improve the policies, processes, and procedures for assisting identity theft victims, we have taken significant steps in the past few years to develop a more consistent, more efficient, and less burdensome manner for handling identity theft cases. Additionally, we are expanding the IRS identity-theft strategy to address recommendations from the President’s 2007 Identity Theft Task Force. We look forward to continuing to work with taxpayers, stakeholders, and the National Taxpayer Advocate in order to identify, develop, and implement additional improvements in this important area of tax administration.

Summary

The FY 2009 Budget request includes significant increases for IRS enforcement efforts. Fully funding that request will help us make progress in improving voluntary compliance. Based on our analysis covering the most recent 11 years of collection experience, we estimate that every dollar we have spent on enforcement has generated a direct return, on average, of four dollars in increased revenue to the U.S. Treasury. This return can be expected to occur when the full productive benefit of the investment is realized. In FY 2007, the return on our enforcement programs rose to 5.6 to 1.

We also believe that dollars spent on taxpayer service have a positive impact on voluntary compliance. Research has shown us that the complexity of the U.S. tax code is an important factor in the ability of many taxpayers to remain compliant with tax laws. Even sophisticated taxpayers can make honest mistakes on their tax returns.

Accordingly, helping taxpayers understand their obligations under the tax law is a critical part of improving voluntary compliance. To this end, the IRS remains committed to a balanced program assisting taxpayers in both understanding the tax law and remitting the proper amount of tax.

In addition, the President’s FY 2009 Budget contains a number of legislative proposals that provide additional tools for the IRS to enforce the existing tax law. Perhaps the most critical of these tools is greater third-party reporting.

An analysis of the data from the National Research Program of TY 2001 individual income tax returns leads to one very obvious conclusion. Compliance is much higher in those areas where there is third-party reporting. For example, only 1.2 percent of wages reported on Forms W-2 are underreported. This compares to a 53.9 percent underreporting rate for income subject to little or no third-party reporting. Congress' continued support of third-party reporting requirements will help the IRS fulfill its mission and reduce the tax gap.

The FY 2009 Budget request asks Congress to expand information reporting to include additional sources of income and make other statutory changes to improve compliance. These legislative proposals are intended to improve tax compliance with minimum taxpayer burden. When implemented, it is estimated that these proposals will generate \$36 billion over ten years.

Finally, full funding of the budget request will enable the IRS to improve our research and our understanding of what drives taxpayer compliance. Despite all of our progress, there is still much we do not know about the drivers and the overall size of the tax gap. Although the updated estimates provided by the NRP study are more accurate than our previous estimates, and more accurate than the estimates made at various times by others using more indirect methods, they have some significant limitations. These estimates are useful for understanding the general areas and levels of noncompliance and the scope of the problem, but they are far from precise or timely measurements.

I appreciate the opportunity to testify this morning, and I will be happy to respond to any questions that Members of the Committee may have.